COMMENTARY
The Financial Crisis and Global Policy Reforms

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Barry Eichengreen's paper pushed me to take a different look at the crisis and I encourage everyone to read the paper carefully.

I will separate these very brief remarks into three parts. First, I will review his basic observations, concentrating on what I see as his more novel points. Next I will present one picture that informs my thinking on the role of global imbalances in the crisis. Finally, I will extend some of his discussion on incentives that I believe are important for the next steps in regulatory reform.

1. Incentives vs. Global Imbalances

The paper lays out two very different descriptions of the driving factors in the crisis. Depending on one's background, parts of each account are likely to be familiar, but other parts will probably be new. One of the nice aspects of the paper is that it offers a concise but thoughtful account of each perspective. Another novel aspect of the paper is the very appropriate attention to the global policy challenges that lie ahead.

The first view, which I would dub the orthodox, financial economist's account of the crisis, focuses mostly on the problems with "incentives." Incentives here relate to motivating considerations of both regulators and market participants. The main idea is the managers and owners of financial institutions received rewards for investments, loans, and other actions that may not be in society's interest. Unfortunately regulators did not necessarily have the tools or incentives to combat some of the problems that arose.

This view leads to most of the now standard list of prescriptions for regulatory reform. The standard list of candidate reforms includes strengthening capital regulation to require banks to hold more capital; changing the regulations that govern the resolution of an impaired institution; mandating

Author's Note: *These views are entirely my own and should not be interpreted as reflecting any of the organizations with which I am affiliated.*

better disclosure of information to bank regulators; reforming the structure of derivatives contracts to make them less disruptive in the event of bankruptcy; restricting the form of compensation contracts to better align employee and shareholder interests; and creating a new macroprudential regulator to look across the financial system and focus on its stability.

I agree with his concern that even some of the least controversial of these suggestions will be met with resistance by domestic groups who stand to be constrained by such changes. Coordinating globally will be even harder. The so-called Basel II reform took about a decade and these proposed changes are in many respects more fundamental and wide-reaching. I expect that many of these topics will remain on the table for the next few times that this conference convenes.

Within this set of proposals I am most intrigued by Barry's suggestion to form a World Financial Organization (WFO) that would be akin to the World Trade Organization. The WFO would be tasked with establishing principles for prudential supervision, but not necessarily getting into the details of the structure of regulation. It would define obligations for its members, and countries would be compelled to join in order for their domestic financial institutions to have free access to foreign markets. The WFO would monitor members' compliance with the rules and impose sanctions for noncompliance.

I like several aspects of this suggestion. First, it is bold. Why should the next iteration on reform proceed by moving around the boxes on the existing organizational charts? Second, it would greatly accelerate global harmonization of the rules, which otherwise will be the last step in the overhaul of the regulatory system. Until the loopholes are closed globally, the likelihood of success of reform is doubtful. Finally, it provides a unified approach to tackling many of the thorniest problems. Absent the creation of something like the WFO, the reforms are likely to be the product of a series of one-off negotiations because so many different changes will be required. This is an idea that deserves serious consideration.

The second perspective, which I will call the global imbalances view, presumes that the flow of savings from emerging economies and oil exporters into developed economies could not be effectively absorbed. The flows depressed interest rates, and monetary and fiscal policies were not effective in preventing large current account deficits in the U.S. and several other countries.

I agree with Barry that global imbalances have not been good for the world economy during this decade. But as he writes, "slightly more convoluted is the link to the particular constellation of financial weaknesses that culminated in the crisis." I would go farther and say that without the incentive problems highlighted in the first view it is hard to see how the global imbalances alone could have been so disruptive. I present more on the basis for this claim later.

Nonetheless, the events starting in 2007 still have a number of lessons for policymakers. Perhaps most important is that inflation targeting as practiced needs to be changed. As advocates of inflation targeting point out, today, in light of the unprecedented monetary accommodation that is in place, it is valuable to have an inflation objective to help anchor expectations. So we should not abandon it. But inflation targeting let us down a bit during the middle of this decade. The imbalances that were building were perhaps too easily dismissed as harmless because inflation was on target. It appears that a new consensus is emerging that suggests we will need to pay more attention to the financial system per se. In regulating it, other tools in addition to the short-term interest rate should be the first line of defense.

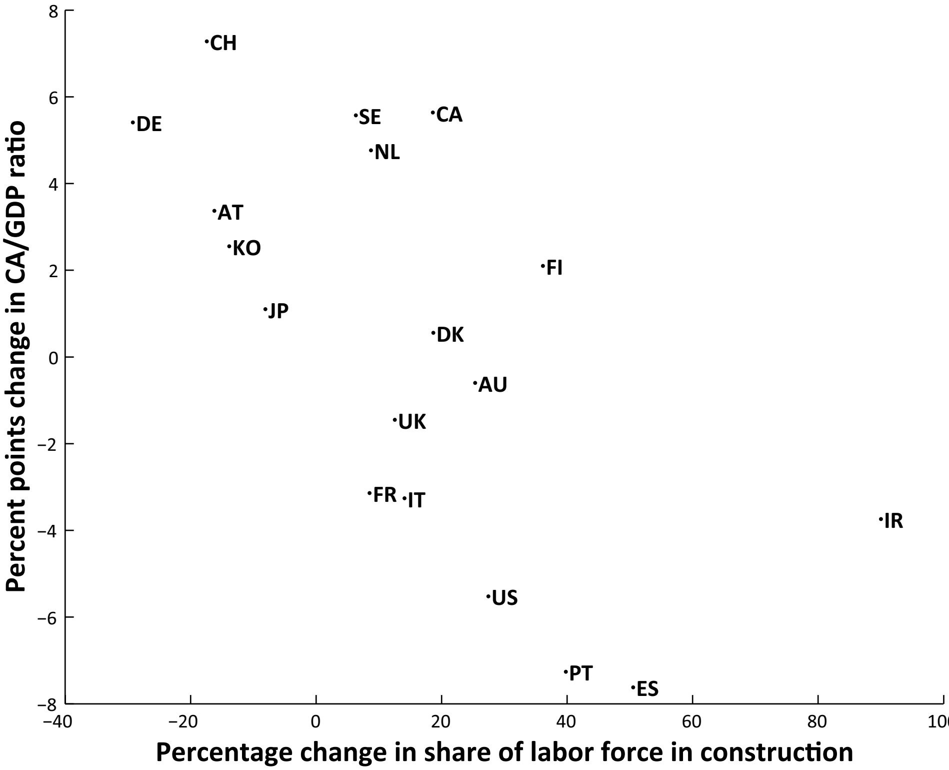
Barry points out that we also saw that either large current account surpluses or deficits have proved difficult to manage. Likewise, that procyclical fiscal policy and reserve accumulation have contributed to problems that we are now facing. Finally, he notes that the failure to let relative prices move in response to shifts in demand is undesirable.

2. Current Account Deficits and Banking Problems

I agree with all of these conclusions. But I believe that even if all of this advice had been followed, the incentive issues in the financial system were still likely to have caused problems. One basis for this claim are the data presented in Figure 1. These data are from Gete (2009) and show the association between the change in the current account and the share of labor in the construction for major economies between 1994 and 2006. One can see that current account deficits and housing booms occurred together during this period— this is the point of Gete's paper and he shows that this pattern is evident using many different measures.

The banking problems, however, were not closely correlated with the current account imbalances. Banks in Switzerland and Germany, which saw their current accounts swing strongly toward surpluses, managed to get into plenty of trouble during the crisis. But so did banks in the U.S. where the patterns were reversed. Thus, the simplest story that a flood of savings poured into some countries and the banks in those countries could not absorb them does not look correct. A better story seems to be that the banks in most developed countries engaged in similar strategies and got into similar sorts of trouble. Perhaps the

FIGURE 1
Current Accounts and Labor Devoted to Construction, 1994–2006



Source: Gete (2009).

magnitude of the problems would have been reduced if the global economy had been better balanced, but I think the chances of avoiding a crisis were low.

3. More on Incentives

Given the primary emphasis I put on the role of incentives in exacerbating the crisis, I want to close by elaborating on some of the points Barry only briefly mentions and raise a couple of related observations.

In passing, in footnote 10, Barry mentions the problem of having the right compensation structure for regulators. This I fear is a much more serious challenge than he makes it out to be. Let me offer some numbers to put the problem in perspective. Bertand, Goldin, and Katz (2009) note that the *median* salary and bonus for an MBA graduate from the University of Chicago who graduated between 1990 and 2006 and started out working as an investment banker and has nine years of experience is $470,000 per year (regardless of whether he stays in investment banking). Perhaps more relevant, my informal sample of salaries last year for new PhDs in finance who received job offers at mid-tier business schools was a nine-month salary of roughly $160,000. Typically these offers include an additional 22 percent stipend of summer support for the first few years of the contract.

This is the market in which the systemic risk regulator (SRR) will have to compete for talent. Assuming the SRR wants to hire roughly 50 PhDs, it is highly doubtful that this can happen given the existing pay norms at the U.S. Treasury or Federal Reserve. As already discussed, many of the looming regulatory challenges will require foundational research. If the staff of the SRR is not on the research frontier, the odds of success are low. Therefore, if the SRR is going to be effective, the compensation question will have to be addressed. The model developed to staff the Public Company Accounting Oversight Board suggests that this problem is not insurmountable, but it will require breaking away from the current government norms.

A second question is what tools will we give to the SRR? One of the disturbing aspects of the crisis is that there were some warnings offered that were ignored. The most persistent warnings came from the Bank for International Settlements (BIS). We (policymakers, politicians, and academics) should all ask why these concerns were ignored.

My conclusion is that part of the problem was that the BIS had no instruments with which to affect policy. This suggests that the SRR cannot be relegated to a pure monitoring role if it is to avoid the same fate. Thus, I favor starting the discussion soon about which policy levers we will give the SRR. There are many options for doing this (see Squam Lake Working Group 2009 and Kashyap and Stein 2009 for some options, so this is more a matter of choosing from existing ideas than developing new ideas.

Summing up, Barry's paper offers an excellent tour of the issues ahead. It would be great if we were to embrace many of the suggestions that he offers. But more important than the particular choices that are made is that we act now to prevent the problems we have seen over the last two years from reoccurring.

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